



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations

625 Fulton Street, Room 503

Brooklyn, NY 11201

501.03-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

January 12, 2009

Release Number: **201017078**

Release Date: 4/30/10

LEGEND

ORG = ORGANIZATION NAME

XX = DATE

ADDRESS = ADDRESS

ORG

ADDRESS

Taxpayer Identification Number:

Person to Contact:

Identification Number:

Contact Telephone Number:

LAST DATE FOR FILING A PLEADING
WITH THE TAX COURT, THE CLAIMS,
COURT, OR THE UNITED STATES
DISTRICT COURT FOR THE DISTRICT
OF COLUMBIA: April 12, 20XX

CERTIFIED MAIL

Dear

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated December 30, 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s):

You are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you are not engaged primarily in activities which accomplish charitable, educational or other exempt purposes as required by Treas. Reg. 1.501(c)(3)-1(c)(1). Your activities, including your financial transactions, more than insubstantially furthered non-exempt purposes. Moreover, you failed to establish that you did not operate for the benefit for the private interest of a private shareholder or individual, as required for continued recognition of exemption pursuant to Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Your income inured to the benefit of private shareholders and individuals.

Contributions to your organization are no longer deductible under IRC §170 after

January 1, 20XX.

You are required to file income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the tax year ending December 31, 20XX and for all tax years thereafter in accordance with the instructions of the return. You have filed taxable returns on Form 1120 for the years ended December 31, 20XX, December 31, 20XX, December 31, 20XX and December 31, 20XX with us.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91st Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

We will notify the appropriate State Officials of this action, as required by Code section 6104(c). You should contact your State officials if you have any questions about how this final determination may affect your State responsibilities and requirements.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Nanette M. Downing
Acting Director, EO Examinations

Enclosure:
Publication 892

Letter 3607(04-2002)
Catalog Number: 34198J



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
9350 Flair Dr., 2nd Floor
El Monte, CA 91732-2828

October 21, 2009

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Sunita B. Lough
Director, EO Examinations

Enclosures:
Publications 892 & 3498
Report of Examination
Form 6018

Form 886-A (Rev. January 1994)	EXPLANATION OF ITEMS		Schedule number or exhibit
Name of Organization/Taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX	

LEGEND

ORG = Organization name XX = Date Address = address City = city State = State President = president DIR-1, DIR-2, DIR-3, DIR-4 & DIR-5 = 1ST 2ND 3RD 4TH & 5TH DIRECTORS CO-1 THRU CO-9 = 1ST, 2ND, 3RD, 4TH, 5TH, 6TH, 7TH, 8TH & 9TH COMPANIES

ISSUE

1. Whether the activities conducted by ORG ("ORG") throughout the years of its existence were in compliance with the rules and regulations under the Internal Revenue Code ("the Code") §501(c)(3).
2. Whether ORG's net earnings inure to the benefit of its officers and board members within the meaning of the Income Tax Regulations ("the Regulation") §1.501(c)(3)-1(c)(2).
3. Whether ORG complied with record keeping requirements as required under the Code §§ 6001 and 6033.

FACTS

Organizational Information:

ORG was incorporated on 8/22/XX, in the State of State. The specific purpose of the organization, as stipulated by Article II of the Articles of Incorporation is "to engage in the solicitation, receipt and administration of property and from time to time to disburse such property and the income therefrom for activities related to the development of new housing, for low to moderate income families, or for other charitable purposes, in accordance with Section 501(c)(3) ..."

The Internal Revenue Service ("The Service") received the Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue code*, signed by President, the President of ORG, on 10/2/XX. Its intended purposes as described in the application were:

“(1) Rehabilitation of dilapidated single family dwellings

- (a) The organization will purchase dilapidated single family dwellings from the Department of Housing and Urban Development ("HUD"). These units will be HUD repossessions. The purchase price for each unit will be based on an independent appraisal. The purchase of each unit will be financed through loans from HUD (approximately 85% of the purchase price) and loans (at market interest rates) from private investors, including President, the president of the organization (approximately 15% of the purchase price). The organization will then rehabilitate each unit so that it meets all applicable building codes and is suitable for marketing. All rehabilitation work will be done by local building contractors at prevailing rates. (Contractors will be unrelated to the officers or directors of the organization.) The rehabilitation of each unit will be financed through loans from HUD (approximately 85% of rehabilitation costs) and loans (at market or below market interest rates) from private investors, including President, the president of the organization (approximately 15% of rehabilitation costs). This activity will consume about 50% of the organization's time.

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This activity furthers the organization's goal of rehabilitating existing housing stock in depressed urban neighborhoods, thereby helping to halt the deterioration of such neighborhoods and contributing to their revitalization.

- (b) This activity will begin as soon as the organization locates a suitable property being offered for sale by HUD, and HUD determines that the organization is eligible to participate in its sale and loan programs.
- (c) This activity will be conducted in depressed urban neighborhoods located within City.

...

The organization's president, President, will handle all day to day tasks related to purchase, rehabilitation, and financing of housing units. ...

(2) Sale of rehabilitated dwellings to very low, low and moderate income families

- (a) The organization will sell the units it rehabilitates to very low, low and moderate income families at market prices. The units will be marketed through periodicals and through local real estate agents who specialize in homes for very low, low and middle income buyers. The organization will provide education and advice to first-time homebuyers, especially with regard to available sources of financing. This activity will consume about 30% of the organization's time. This activity furthers the organization's goals of (i) assisting very low, low and moderate income families to achieve the goal of home ownership and (ii) contributing to the stability and revitalization of depressed urban neighborhoods by helping families become "stakeholders" in those neighborhoods. ...
- (b) This activity will begin as soon as the organization completes rehabilitation of its first property.
- (c) This activity will be conducted in depressed urban neighborhoods located within City. The organization's president, President, and volunteers who support the organization's goals will handle all day to day tasks related to marketing and sales,...

(3) Development and support of after-school tutoring and sports programs for "at risk" high school and junior high school students

- (a) All profits from the sales of rehabilitated units will be used to finance after-school tutoring and sports programs for "at risk" high school and junior high school students. The organization will work with school district personnel and other non-profit organizations to strengthen existing programs and to develop new programs of this type. It is anticipated that most programs will recruit and compensate credentialed teachers and physical education instructors to provide students with academic tutoring and sports instruction after school hours. This activity will consume about 20% of the

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organization's time. This activity furthers the organization's goals of providing constructive activities for "at risk" youth which will encourage them to stay in school and which will counteract the negative influences which they encounter each day.

- (b) This activity will begin as soon as the organization realizes a profit from the sale of rehabilitated units.
- (c) Initially, the organization will focus on developing and supporting programs at School, located in City, State, and School-2, located in City, State. The organization's president, President, and volunteers who support the organization's goals will handle all day to day tasks related to the development and support of these after-school programs."

A determination letter was issued on 12/30/XX granting exemption status under the Code § 501(c)(3) as an organization described under the Code § 509(a)(2) with an advanced ruling period through 12/31/XX. The Service reaffirmed the exempt status of ORG as a publicly supported organization in 20XX.

Issue 1 – Operational Test

On 6/28/XX, the Service initiated a review of the Forms 990, *Return of Organization Exempt From Income Tax*, and activities of ORG for the years ending 12/31/XX. ORG was involved in two separate but related activities. One of the activities was rental for residential purpose. ORG owned two properties in the beginning of 20XX and rented them out.

The other activity that ORG was involved in was the purchasing, refurbishing and reselling of HUD properties. This activity began in 19XX and reached its peak in 20XX and then tapered off. By 20XX, ORG was no longer purchasing properties from HUD. However, ORG fixed-up and sold one of the properties on 1/12/XX.

Forms 990 filed by ORG indicated that board members of ORG were the same since 19XX. President was the President, DIR-1, DIR-2 and DIR-3 were directors. DIR-1 and DIR-3 were also directors of CO-1 ("CO-1") during the same period.

ORG stopped its operation and dissolved its assets in early 20XX. The remaining single property was transferred to CO-1, and cash assets of about \$ were contributed to other exempt organizations.

The other activity that ORG was involved in was purchasing, refurbishing and reselling HUD properties. This activity began in 19XX and continued through 20XX. During these years, ORG purchased 20 properties from HUD. Two of these properties were sold to DIR-4, the president of CO-1.

We reviewed Forms 990 for the years ending December 31, 19XX through 20XX. The sales of the properties were only in 19XX through 20XX, and they were reported on Forms 990 as follows:

Account Description	19XX12	20XX12	20XX12	20XX12	20XX12	20XX12
Res. Property sales						
Fees & contracts from gov't agencies						

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Total Income						
Acquisition costs						
broker commission						
buyer costs pd by seller						
carrying costs						
Closing costs						
closing costs at Acq						
Closing costs paid by seller						
Development fees						
Rehab costs						
Total Expenses						
Net Gain (loss)						
% Net Gain (loss)						

The table above appeared to indicate that ORG made little or no profits from these transactions. However, President received substantial compensation and benefits. The follow table is a summary of the expenses reported on Forms 990 and displays how the funds earned from the two activities were utilized for the years 19XX through 20XX.

Account Description	19XX12	20XX12	20XX12	20XX12	20XX12	20XX12
Comp to officers, directors, etc.						
Pension plan contribution (n1)						
Health insurance						
Payroll Taxes						
Total pymt to/for A. Gooch						
Other expenses						
Total Office/Administrative Expenses						
% paid to/for A. Gooch						

The table above indicates over 85% of office/administrative expenses in 19XX through 20XX were paid to President in the forms of compensation and benefits, which was substantially higher than the \$ estimated annual compensation to him on Form 1023.

In the Form 1023, ORG indicated it would be operating after-school programs for “at risk” school students. There were no records supporting the existence of or expenses incurred for the purpose of this activity.

Issue 2 – Net Earnings Inuring to the Benefit of an Insider

Cancelled checks indicated that ORG made the following payments to an entity wholly owned by DIR-4, CO-2 (“CO-2”):

Payee	Date	Ck#	Amount	Total
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Form 886-A (Rev. January 1994)	<h2 style="margin: 0;">EXPLANATION OF ITEMS</h2>	Schedule number or exhibit
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CO-3	01/01/XX			
	01/12/XX			
CO-2	02/03/XX			
Total				

CO-2 was formerly known as CO-3. In response to our request for supporting records, ORG states that it “does not have any written bills, invoices, service contracts, etc. for any of these payments.”

Facts Applicable to All Issues:

President and DIR-4 owned and/or controlled the following entities during the years. Most, if not all, of these entities utilized the same office space and staff paid for by CO-1:

Entity Name	DIR-4	President
Address, City State	owned 25%	owned 25%
CO-4	owned 25%	owned 25%
CO-5	owns 50%	owns 50%
CO-6 (“CO-6”)		owns 100%
CO-2 (“CO-2”)	owns 100%	
CO-7	owns 100% through his wife	
CO-8 (“CO-8”)	owns 50%	owns 50%
CO-1. (“CO-1”)	President	
CO-9	owns 50%	owns 50%

In the year 20XX, CO-1 paid \$ to/for CO-6. President, owner of CO-6, was unable to provide sufficient documentation to substantiate the purpose of these payments.

During the years 20XX through 20XX, five properties owned by CO-1 were quitclaimed out of CO-1 and eventually went to CO-8 (“CO-8”). CO-8 was equally owned by President and DIR-4. In exchange for each of the five properties, CO-8 assumed the outstanding mortgage of these properties. The outstanding mortgages were substantially below fair market values of the properties.

CO-1 had 2 full-time employees, DIR-4 and the office manager. Since 5/1/XX, CO-1 provided health insurance coverage for the entire family of these 2 employees. However, beginning on 5/1/XX CO-1 also provided health insurance for President’s family at \$ per month. We questioned why CO-1 was paying for President’s family and the response was “It was agreed that CO-1 would pay the health insurance for President from 5/1/XX. His

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insurance was paid for until 10/26/xx.” DIR-5 was a board member of CO-1. However, no other board members received the same benefit from CO-1.

Minutes of Meetings:

In response to our request for the minutes of the meetings of the governing body, including committee meetings, ORG provided the minutes of annual meetings for 20XX without a date as to when it was held. The signature page was not provided. It contains the following statements:

Minutes of Annual Meetings of Both Shareholders and Directors of

ORG

We, the undersigned, being all of the shareholders, directors, and the secretary of the Corporation, hereby agree and consent that the annual meeting of the shareholders and the annual meeting of directors of the Corporation be held on the date designated hereunder, and do hereby waive all notice whatsoever of such meeting and of any adjournment thereof.

We do further agree and consent that any and all lawful business may be transacted at such meetings or at any adjournment or adjournments thereof as may be deemed advisable by any shareholder or director present thereat. Any business transacted at such meetings or a any adjournment or adjournments thereof shall be a valid and legal and of the same force and effect as if such meeting or adjourned meetings we held after the notice.

The directors and shareholders of this company pursuant to statutory requirements of that law held its annual meeting of the shareholders and immediately thereafter, held its annual meeting of board of directors as of the day set forth below.

The undersigned constituting all the shareholders, directors, and the secretary of this company hereby acknowledge that by placing their signatures below they consent to the waiver notice of these meetings and consent to said meetings being held by said shareholders, board of directors and secretary.

Upon motion duly noted and seconded and unanimously carried out, the following was considered and voted upon by the undersigned. ... [The minutes listed some of the matters that took place during the year.]

ORG has not paid dividends. ...

There being no further business to come before the meeting of the undersigned, upon motion duly make and seconded and unanimously carried, the meeting was adjourned.

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A review of ORG's Bylaws indicate that Section 6.03 states, "Directors shall be elected at each annual meeting of the board of directors to hold office until the next annual meeting by plurality vote of the directors in office immediately preceding the election; ..."

Section 6.06 of the Bylaws states, "Annual meetings of the board of directors shall be held for the purpose of organization, election of directors and officers and the transaction of other business. Annual meetings shall be held on the fifteenth day of February of each year at 10:00 a.m."

Section 6.09 of the Bylaws states "A majority of the authorized number of directors shall constitute a quorum for the transaction of business ... A meeting at which a quorum is initially present may continue to transact business, notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting."

We compared the minutes to the bylaws to see whether ORG complied with its own rules, and observed the following inconsistencies:

- With the reference to shareholders and dividends, the minutes appear to follow the format of a for-profit corporation.
- The minutes did not mention which officers and board members were present, and whether a quorum was met.
- Although the minutes didn't indicate when it was held, the content indicated it was held at the end of the year. The Bylaws required it to be held on or the next working day after the fifteenth day of February.
- There were no elections of directors.
- The nearly \$ in payments to CO-2 represented a substantial expenditure. However, there were no discussions or approval by the board.

LAW

The Code §501(a) states "An organization described in subsection (c) ... shall be exempt from taxation under this subtitle."

The exempt organization listed under the Code §501(c)(3) is described as "Corporations... organized and operated exclusively for religious, charitable ... **no part of the net earnings of which inures to the benefit of any private shareholder or individual...**" [Emphasis added.]

The Income Tax Regulations ("the Regulation") §1.501(a)-1(c) states "The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization."

The Regulation §1.501(c)(3)-1(c)(1) states "An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

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The Regulation §1.501(c)(3)-1(c)(2) states “**An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.**” [Emphasis added.]

The Regulation §1.501(c)(3)-1(d)(1)(ii) states “An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”

The Regulation §1.501(c)(3)-1(d)(1)(ii), although states in terms of the "net earnings" of an organization, the inurement doctrine applies to any of an organization's charitable assets. *See People of God Community*, 75 T.C. 127, 133 (1980). Payment of excessive compensation is a form of inurement. For example, in *Mabee Petroleum Corp. v. U.S.*, 203 F. 2d 872, 875 (5th Cir. 1953), the Fifth Circuit held that the organization's payment of a full-time salary for part-time work was inurement.

The Regulation §1.501(c)(3)-1(d)(2) states “The term “charitable” ... includes: Relief of the poor and distressed or of the underprivileged; ... or (iv) to combat community deterioration and juvenile delinquency.”

In *Better Business Bureau of Washington, D.C. v. U.S.*, 326 U.S. 279, 283 (1945), the Supreme Court held that the “presence of a single...(nonexempt) purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly...(exempt) purposes.”

Revenue Ruling 70-585, 1970-2 C.B. 115, provides that nonprofit housing organizations created to aid low and moderate income families by lessening neighborhood tensions, eliminating prejudice and discrimination, and combating community deterioration may qualify for exemption under §501(c)(3) of the Code.

Receipt by an exempt organization of less than fair market value in a sale or exchange of property with an insider is also a form of inurement. In *Sonora Community Hospital v. Commissioner*, 46 T.C. 519 (1966), two doctors transferred their private practice of medicine, including the building in which the practice was housed, to a non-profit hospital they controlled. A portion of the building was occupied by a for-profit laboratory under a prior agreement with the two doctors. The doctors caused the hospital to acquiesce in the arrangement with the laboratory. The hospital received no consideration for the assignment of its space to the laboratory either as part of the sale or through a share of the laboratory's gross revenues. Payments in consideration of the assignment that should have been paid to the hospital were paid directly to the two doctors. The doctors performed no services for the laboratory. The Tax Court held that the arrangement resulted in an inurement of the hospital's charitable assets to the two doctors.

In *Anclote Psychiatric Ctr. v. Commissioner*, T.C. Memo 1998-273 (1998), an organization's board of directors caused the organization to sell its largest asset – a hospital – to a for-profit entity formed by the directors. The board of directors obtained an independent appraisal of the hospital and hired independent counsel to represent the organization. The closing, however, occurred almost two years after the appraisal. The parties failed to make adjustments to the values established in the appraisal. The Tax Court determined that the purchase price received by the organization on the sale of the hospital was not within a reasonable range of what could be

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considered fair market value. Accordingly, the Tax Court held that the sale transaction resulted in inurement within the meaning of §501(c)(3).

The provision of inurement can be direct or indirect. In *Anclote Psychiatric Ctr., supra*, the sale transaction giving rise to the inurement was between an exempt organization and a for-profit corporation formed by the organization's directors. Although the for-profit corporation was the direct beneficiary of the below-market sale transaction, the Tax Court held that the transaction resulted in "an advantage" to the shareholders of the for-profit corporation and that this "advantage" constituted inurement of the organization's charitable assets to the shareholders.

In *Church by Mail, Inc. v. Commissioner*, 765 F.2d 1387 (9th Cir. 1985), the Ninth Circuit treated as inurement compensation paid by a controlled entity to the organization's insiders. In *Church by Mail*, two individuals, Reverend Ewing and Reverend McElrath, ran a church that mailed printed sermons to several million homes. They also owned a for-profit advertising agency which provided the Church's printing and mailing services. The Ninth Circuit found that the combined compensation paid to Reverend Ewing and Reverend McElrath by the Church and the advertising agency was excessive. The Ninth Circuit rejected the Church's argument that the portion of the compensation paid by the advertising agency should not be included in the determination of reasonableness and treated this portion as indirect inurement of the Church's earnings to the Church's insiders. *Id.* The Ninth Circuit based its conclusion on the following legal principle: "[W]hen a second organization is created which serves to funnel income to the individual who controls the purportedly exempt organization and the income exceeds a reasonable salary, the income inures to the benefit of a private person within the meaning of I.R.C. section 501(c)(3)." *Id.*

Indirect inurement can occur even if the organization's insiders are not formally in control of the intermediary used to funnel the funds from the organization to the insiders. In *Church of Scientology of California v. Commissioner*, 823 F.2d 1310, 1315 (9th Cir. 1987), the organization transferred in excess of \$ 3.5 million to a for-profit corporation incorporated by the organization's founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. At the time of the transfer, the founder and his wife were not directors, officers or employees of the corporation. The founder was no longer serving as the head of the church but continued to exert significant control over the church by making policy statements, directives and orders. 823 F.2d at 1314. In particular, his approval was required for all financial planning. *Id.* The directors of the corporation approved the founder's decision to transfer \$ 2 million from the corporation's account to the ship *Apollo* aboard which the founder and his family lived. The Ninth Circuit held that the organization's funds funneled through the corporation constituted inurement to the founder and his family. 823 F.2d at 1318.

The prohibition on inurement in the Code §501(c)(3) is absolute. The Service has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement. See *Spokane Motorcycle Club v. U.S.*, 222 F.Supp. 151 (E.D. Wash. 1963); *The Founding Church of Scientology*, 412 F.2d 1197, 1202; *Airlie Foundation*, 283 F. Supp. 2d 58. Moreover, for purposes of establishing that inurement occurred, it is not necessary to calculate the precise amount of inurement as long as it is shown that the value of the transfer giving rise to inurement is not within a reasonable range of what could be considered fair market value. See *Anclote Psychiatric Ctr. v. Commissioner*, T.C. Memo 1998-273.

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Record Keeping Requirement

The Code § 6001 states, “Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.”

The Code §6033(a)(1) states, “In general. ... every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe...”

The Regulation §1.6001-1(a) states, “*In general.* ... any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.”

The Regulation §1.6001-1(c) states, “*Exempt organizations.* —In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033.”

The Regulations §1.6001-1(e) states, “*Retention of records.* —The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.”

The Revenue Ruling 59-95, 1959-1 CB 627, (Jan. 01, 1959) states, “An organization previously held exempt from Federal income tax was requested to produce a financial statement as of the end of the year and a statement of its operations during such year. However, its records were so incomplete that it was unable to furnish such statements. ... *Held*, failure or inability to file the required information return or otherwise to comply with the provision of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of an exempt status.”

Effective date of revocation

The Regulation §1.501(a)-1(a)(2) states “Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause... an organization that has been

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determined by the Commissioner or the district director to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation.”

The Regulation §601.201(n)(3)(ii) states a “ruling or determination letter recognizing exemption may not be relied upon if there is a material change inconsistent with exemption in the character, the purpose, or the method of operation of the organization.”

The Regulation §601.201(n)(6)(i) states “[a]n exemption ruling or determination letter may be revoked or modified by a ruling or determination letter addressed to the organization... The revocation or modification may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented...”

GOVERNMENT POSITION

Issue 1 – Operational Test

In order for an organization to retain its exempt status it must demonstrate to the Service that it meets both the organizational and the operational tests. The facts stated above indicate that ORG failed the operational test.

Charitable purposes include relief of the poor and distressed, the Regulation §1.501(c)(3)-1(d)(2). ORG’s rental activity and selling of real properties in the manner described above doesn’t address the needs of low-income people. In fact, the rental activity and the selling of real properties were operated in a manner no different than other business entities that are engaging in such activities in a commercial manner.

In 20XX ORG sold 2 properties. Fixing and selling properties at market rate doesn’t constitute assisting low-income families. Therefore, the activities as described above did not meet the operational test as described under §1.501(c)(3)-1(c) of the Regulation.

ORG has bylaws but chooses not to comply with them. It held the annual board member meetings in December instead of February. It made no elections during the annual meetings. It did not discuss and/or approve many of the significant matters that took place during the years. These actions represent ORG disregarding its own rules and regulations, which in turn indicates that ORG did not meet the operational test as described under §1.501(c)(3)-1(c) of the Regulation.

Issue 2 – Net Earnings Inuring to the Benefit of an Insider

Although, DIR-4 wasn’t an officer or director of ORG, the facts and circumstances indicate that he had significant influence over ORG. Therefore, DIR-4, President and all entities they own/owned are private shareholders or individuals within the meaning of the Regulation §1.501(a)-1(c).

In the year 20XX, ORG paid \$ to CO-2, an entity wholly owned by DIR-4, a private shareholder or individual within the meaning of the Regulation §1.501(a)-1(c). ORG failed to provide sufficient substantiation that the payments were for the expenses incurred on ORG’s behalf. The board members of ORG did not approve these

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payments. Therefore, all payments paid to or for CO-2 constitute inurement to DIR-4, and represent an act prohibited by the Code §501(c)(3).

Issue 3 – Record Keeping Requirement

Through out the examination, ORG was unwilling or unable to produce the records necessary to support and substantiate the financial information reported on the annual returns it filed. Accordingly, ORG failed to comply with requirements under the Code §§ 6001 and 6033 and the Regulations thereunder.

CONCLUSION

Based on the information secured during the examination, we conclude that ORG is not operated for exempt purposes under §501(c)(3) of the Code. An organization can not be recognized as exempt under §501(c)(3) unless it shows that it is operated exclusively for charitable, education, or other exempt purposes and its net earnings does not inure to the benefit of any private shareholder or individual. Among other things, ORG's activities must demonstrate conclusively that it meets the operational test of §1.501(c)(3)-1(c) of the Regulations. The activities show that the primary purpose is renting properties out to the general public; which does not exclusively serve a purpose described in §501(c)(3) of the Code. It also engaged in many transactions enabling its net revenues to benefit DIR-4, the private shareholders or individuals of ORG. Therefore, the exempt status granted to ORG should be revoked effective from January 01, 20XX in accordance with the Regulation §601.201(n)(6)(i).